Tax Reform:

SHOULD WE CAP PROPERTY TAXES OR HANG OUR HATS ON OTHER OPTIONS?

Capping the growth in local property taxes is no guarantee that taxpayers' burdens will ease. Nor does it seem to have the sort of efficiency gains that might translate into improved public sector performance.

BY STEVEN P. LANZA

In the name of property tax reform, Governor Rell is again pushing a proposal, shelved last year, that would after a period of transition limit most local property tax growth to 3%. No question, Nutmeggers labor under a heavy property tax load. Connecticut ranks 2nd among U.S. states in property taxes per capita, 4th in such taxes as a percent of income, and 10th as a percent of home value. And with the growth in local property taxes outstripping inflation in recent years, our rankings could worsen. Even so, capping the growth in local property taxes is no guarantee that taxpayers' burdens will ease. Nor does it seem to have the sort of efficiency gains that might translate into improved public sector performance.

TAXING ISSUES

The property tax is the cornerstone of local government finance. According to the Tax Foundation, a Washington-based policy research organization, property taxes provide about 28% of total local government revenue in the U.S. and nearly three-quarters of towns' own tax collections. Grants from state and federal governments (39%) and user fees and other non-tax charges (23%) make up the balance. In Connecticut, property taxes are the sole source of local tax revenue, and non-tax user fees contribute less than 10% to the total.

The activities of local government run the gamut: from parks and recreation to public safety and transportation. But elementary and secondary education command the lion's share of local public monies both in Connecticut, where it accounts for more than half of local budgets, and across the nation.

Local government expenditures have swelled of late. In the latest ten year period (1995-2005) for which the U.S. Census of Governments has published data, local government spending climbed 73% in the U.S., and by 59% in Connecticut. Faster population growth nationally accounts for virtually all of the differential change in spending. On a per-capita basis, local spending (and local property taxes) increased by about 50% in both the U.S. and the state, during a period when the price level rose less than 30%.

So even after accounting for population and price-level increases, local spending and taxes have gone up by approximately 20% (50% - 30%) in the last ten years. What gives?

For one thing, many local government services—public parks, for example—are (in economics-speak) normal goods: items that people demand in larger quantities as their incomes go up. Translation: the richer people are, the more local government services they crave.

Another source of the problem is the dreaded unfunded mandate. Higher levels of government often require localities to provide services, like special education, without necessarily writing checks big enough to cover the added costs. What's more, the price of those services, which are by definition labor-intensive, has increased faster than the overall price level in recent years. The price of education services, for example, has increased more than 2.5 times faster than the rate of prices overall in the past decade.

And though the share of local revenue from federal and state grants has held steady in the past ten years, that fixed share of support hasn't obviated the need for localities to increase taxes on a par with the increases in spending. The subsequent jump in tax bills is giving property tax payers sticker shock and prompting calls for reform, and not just in Connecticut.

Property tax restrictions on local governments are nothing new—they've been around since the late nineteenth century. In modern times, the granddaddy of the property tax reform movement was California's Proposition 13, championed by the irascible 74-year old Howard Jarvis. Saddled with soaring tax bills, and armed with the power of the referendum, California citizens voted 2 to 1 in 1978 to limit property taxes to 1% of market value and restrict tax increases to no more than 2% per year.

Massachusetts weighed in with its own version of property tax reform two years later, when it passed Proposition 2½. Unlike California, which limited tax rates, Massachusetts capped property tax levies, limiting the amount of total revenue that localities could raise using property taxes. Governor Rell's proposal hews more closely to the Massachusetts than to the California approach. (See the centerfold for a map showing the recent growth in property taxes across Connecticut towns.)

PROMISES, PROMISES

Advocates of property tax limitations claim that such restrictions can reduce local residents' tax bills without compromising the quality of local services. The implicit assumption (or explicit assertion) is that waste and inefficiency are driving up the cost of public services and that a tax cap can impose the kind of discipline on municipalities that they seem unwilling to impose on themselves.

Opponents insist that no level of government faces more competitive discipline than does local government. Residents unhappy with the mix of public services and taxes need only "vote with their feet" and move to another municipality with a more attractive combination of taxes and services. That dynamic forces local governments to be efficient and responsive to residents' needs. In this view, the high cost of local government has less to do with waste and inefficiency, and more to do with increases in the cost of health care, other benefits, and wages, which are driving up expenses in all sectors of the economy.

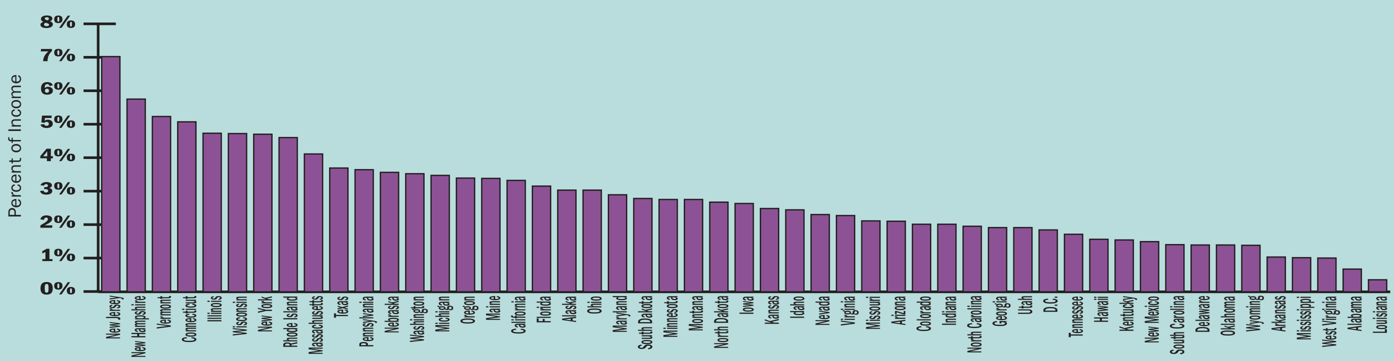
Empirical evidence seems to suggest that opponents of tax limitations have the stronger case.

REALITY CHECK

First, there is little evidence that tax caps do much to constrain property taxes, all things considered. In 2006, property taxes on owner-occupied housing by state ranged from a low of 0.4% of median income in Louisiana to a high of just over 7% in New Jersey. And in that year 29 states had property tax levy limits of the sort Governor Rell proposes. But my regression analysis shows no statistically significant negative link between tax caps and property tax liability across states. The model, which controls for other factors that may explain the property tax burden of individual taxpayers, explains nearly 60% of the variation in the data (see table, overleaf).

Two such "other factors" are the size of the population and the incomes of area residents. Property taxes are higher in larger states with higher

PROPERTY TAXES AS A PERCENTAGE OF INCOME, BY STATE, 2006



SOURCE: *The Connecticut Economy* from Tax Foundation data.

median incomes. Larger populations and wealthier residents tend to demand more public services and accept higher taxes as the unavoidable consequence of this preference. A ten-percent increase in population is associated with a 1/10 of a point increase in taxes as a percent of income; a $10,000 increase in median income produces an 8/10 point increase.

Taxes also vary positively with the quality of local services. Keeping pupil-teacher ratios low, for instance, may be one way to provide a more enriching classroom experience, but doing that takes money. As expected, taxes are higher where pupil-teacher ratios are lower. Reducing the number of students in a classroom by one increases taxes as a percent of income by about 1/10 of a percentage point.

Taxes also depend on the ability of local governments to generate revenue from other sources. Grants from the state or federal level make localities less reliant on local sources of funding. My model suggests that a 10 percentage-point increase in the share of revenue from outside sources lowers taxes as a percent of income by 2/10 percentage points. And where localities have the option to raise revenue through other tax mechanisms, property taxes also tend to be lower. A one percentage-point increase in the share of revenue earned through a local sales tax or income tax reduces property taxes as a percent of income by 1/10 of a percentage point.

After controlling for these factors, the regression model shows no statistical relationship between tax caps and property taxes. Capping taxes does not reduce the share of income that residents are required to pay their local governments—just the opposite of what proponents of caps might hope for.

On the basis of this model, Connecticut's actual tax burden is about what one might predict. Given Connecticut's characteristics, the regression implies that Nutmeggers should pay 5.2% of their incomes in property taxes; we actually fork over 5.1%. Paying taxes in line with expectations would seem to be meager kindling for a taxpayers' revolt.

WHAT EFFICIENCY GAINS?

If tax caps reduced government waste and inefficiency, states with caps should have better-quality public services than those that do not, other things equal. Do they? Let's focus on education since it is the primary obligation of local government.

To gauge (however imperfectly) the educational proficiency of schoolchildren, every state administers the National Assessment of Education Progress (NAEP) to all 4th and 8th graders. Educational research has long recognized that societal characteristics such as race and the educational attainment of the adult population are important determinants of student test scores. Non-minority students and children of parents with college and advanced degrees routinely perform better on standardized tests.

Sure enough, a regression of state level data for 2006 shows that half the variation in scores on the NAEP can be explained by two variables: the percentage of the population that is black, and the percentage of the adult population with at least a bachelor's degree (see table).

We'd like to think that scores would depend on the quality of the educational system, too. And the evidence does suggest that NAEP scores tend to be higher where per-pupil spending is higher, though the link is far less statistically significant.

More efficient school systems should, using the same resources, produce better test results. But after controlling for social conditions and resources devoted to education, schoolchildren in states with tax caps perform no better than kids in states without caps. So tax caps do not have a statistically significant affect on educational proficiency, at least as measured by the NAEP.

That's bad news for tax cap advocates, who have trumpeted the efficiency gains of such a system. But the fears of tax cap *opponents* haven't been realized, either. Tax caps don't seem to have wreaked wholesale havoc on the nation's educational system.

How does Connecticut perform according to the regression results? Again, about as expected. Test scores for the state's 4th graders were slightly above the level predicted by this simple model, while scores for 8th graders were a bit lower than predicted.

EXPLAINING THE VARIATION IN PROPERTY TAXES AND STUDENT TEST SCORES ACROSS STATES

Dependent Variable: Percentage Point Change in Property Taxes as a Percent of Income	Explanatory Variable	Change in Explanatory Variable
+ 1/10	Population	+ 10%
+ 8/10	Median Income	+10,000
+ 1/10	Students per Teacher	- 1-student
- 2/10	Outside Revenue	+10%
- 1/10	Non-Property Taxes	+ 1-point
No change	Tax Caps	

Dependent Variable: Percent Change NEAP Score	Explanatory Variable	Change in Explanatory Variable
+ 5/10	Adults with B.A	+ 10%
- 1/10	Black Population	+ 10%
+ 3/10	Per-Pupil Spending	+ 10%
No change	Tax Caps	

SOURCE: U.S. Bureau of the Census, U.S. Department of Education, and the Tax Foundation

OTHER OPTIONS

These results won't surprise many economists. Most of us dismal scientists would expect a tax cap, at worst, to reduce the quantity or quality of public services, though it need not have any effect at all. Think of rent controls—a cap on the rental price of property. A ceiling *below* the market price leads to non-price rationing (queueing) and a deterioration in housing quality as landlords neglect routine maintenance and improvements—costs they are unable to recoup. But a ceiling *above* the going market price changes nothing: the market is free to clear below the maximum price.

What may be salvaging educational quality in states with tax caps is the weak link between spending and performance to begin with, combined with provisions allowing voters to override the restrictions. Still, such artificial restrictions and the associated escape clauses seem as awkward as they are ineffective.

Are there more sensible ways of controlling local property taxes? The first regression above suggests one possibility. In states where local governments levy separate sales or income taxes, property taxes are lower. So why don't Connecticut municipalities, especially those drawing the most fire for high property taxes, experiment with other tax mechanisms? Then citizens, by their ballots or choice of residence, could opt for the mix of taxes and services they liked best.

In Connecticut, though, state law stands in the way. Under "Dillon's Rule," an opinion articulated by a New Mexico state supreme court judge and upheld by the U.S. Supreme Court in 1907, localities have only the powers expressly granted to them by their states. To have the option of substituting other taxes for the property tax, Connecticut towns would need the approval of the General Assembly and the governor.

A MODEST PROPOSAL

While weighing changes to the taxing powers of cash-strapped local governments, the state might also consider granting localities, particularly cities, the option of taxing land and improvements at differential rates—a version of the so-called land-value tax popularized by the 18th-century political economist Henry George.

One problem with property taxes, and ironically with caps on property tax growth, is that they promote suburban and exurban sprawl. Towns have the incentive to restrict the development of family-friendly housing since families whose kids need educational services often add more to the demand for local services than they do to the tax base. Instead, towns authorize construction of strip malls and big-box stores that expand the tax base but don't sap local services. A tax cap that prevented towns from raising taxes to compensate for the cost of necessary services would likely aggravate the problem, and lead to more strip malls and big box stores in the countryside.

But taxing land at a higher rate than improvements (*e.g.* buildings) changes the incentives. Vacant and abandoned parcels in central cities and older suburbs, in the heart of population and work centers, would become relatively more attractive to developers than raw land on the urban periphery. And developers would have the incentive to economize on the use of land, building up rather than out. In the parlance of economics, land-value taxation promotes development on the intensive rather than extensive margin.

Land-value taxation would probably not reverse a century-long trend of suburban spread, fueled by the automobile and the interstate. But it could be an important weapon in the economic development arsenal, and particularly valuable in helping the state's central cities begin to erase years of blight and neglect.

Land value taxation could be an important weapon in the economic development arsenal, and particularly valuable in helping the state's central cities begin to erase years of blight and neglect.